> on [forward-looking economic cost], the efficient result is for the new entrant to build its own facilities 63/

Forward-looking costs – determined using an economic model or other forward-looking methodology, rather than by reference to an individual carrier's accounting records – more accurately gauges the costs driving economic decision-making by any enterprise Forward-looking costs can also be neutral as between incumbents and new entrants, and between wireless and wireline technologies:

> [W]e find that the use of mechanisms incorporating forward-looking economic cost principles would promote competition in rural study areas by providing more accurate investment signals to potential competitors. * * * Because support will be calculated and then distributed in predictable and consistent amounts, such a forward-looking economic cost methodology would compel carriers to be more disciplined in planning their investment decisions.. 64/

A. The Commission Should Develop Appropriate Forward-Looking Costing Analytical Platforms and Inputs

The first step in developing a new forward-looking cost-based system for computing high-cost support is developing an analytical platform and appropriate inputs with respect to the forward-looking cost – "what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network" 65/ – in areas served by rural ILECs and their competitors The Commission should seek comment on issues such as the following.

63/ *TELRIC NPRM* at ¶ 30

64/ *Universal Service First Report and Order*, 12 FCC Rcd at 8935-36, ¶ 293

65/ *TELRIC NPRM* at ¶ 30

- Whether the existing Synthesis Model provides an adequate model platform for this purpose;

- If so, what modifications to input assumptions (if any) would be needed to apply that model to areas served by rural ILECs and their competitors,

- If the Synthesis Model cannot be used or adapted, how an alternative model platform or other forward-looking cost methodology should be developed 66/

Although, the Rural Task Force expressed reservations about utilizing the existing Synthesis Model to develop support amounts for rural carriers, 67/ the Commission correctly recognized that:

> Many commenters representing the interests of rural telephone companies argue that the Rural Task Force's analysis conclusively demonstrates that the forward-looking cost mechanism should not be used to determine rural company support and that only an embedded cost mechanism will provide sufficient support for rural carriers. *We disagree*. While the Rural Task Force demonstrated the inappropriateness of using input values designed for non-rural carriers to determine support for rural carriers, we do not find that its analysis justifies a reversal of the Commission's position with respect to the use of forward-looking cost as a general matter. 68/

It is also significant that the recent *TELRIC NPRM* seeks comment on forward-looking costing matters with respect to UNEs offered by small ILECs as well as larger carriers. 69/ While UNE pricing entails some different methodological issues

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66/ Western Wireless has demonstrated that it is quite possible to develop an appropriate model to implement a forward-looking cost methodology for rural ILECs *See* James W Stegeman, "Proposal for a Competitive and Efficient Universal Service High-cost Funding Model/Platform," Attachment I to Western Wireless Comments in *Joint Board Competitive ETC Proceeding*

67/ *Rural Task Force Recommendation to the Federal-State Joint Board on Universal Service*, 16 FCC Rcd 6165, 6181 (2000)

68/ *RTF Order*, 16 FCC Rcd at 11311-12, ¶¶ 174-75 (emphasis added)(citations omitted)

69/ *TELRIC NPRM* at ¶¶ 161, 163

than determination of forward-looking costs for universal service high-cost support purposes, there are many related issues, and the Commission can productively address both the UNE pricing and high-cost support issues simultaneously, and can do so using many (if not all) of the same criteria. For example, for purposes of developing appropriate forward-looking inputs to the rural universal service cost methodology, the Commission should consider how to develop dynamically efficient, forward-looking demand estimates that account for the development of facilities-based competition (*i e* , that no single provider's facilities will serve 100% of the consumer demand in any given area) 70/

The Commission's costing analysis efforts in the context of universal service should not be limited to ILEC network costs In many cases, wireless networks may incur lower forward-looking costs to provide basic universal service 71/ For example, in 1998 Western Wireless developed a Wireless Cost Model based largely on the HAI wireline model, but incorporating a wireless network module in place of the HAI model's standard wireline loop module. The Hatfield Wireless Model ("HWM") estimates the cost of wireless service, using cluster population data and ILEC traffic loads to determine cell site, equipment,

70/ *Cf TELRIC NPRM* at ¶ 75

71/ For this purpose, both ILEC and CMRS cost models should estimate the cost of providing the supported services included in the "definition of universal service" *See Federal-State Joint Board on Universal Service*, Order and Order on Reconsideration, 18 FCC Rcd 15090 (2003) (reaffirming existing definition of "universal service") and backhaul requirements, and using the transport, switching, signalling and other cost data from the HAI wireline model 72/

The goal of universal service must be to preserve and advance universal service as efficiently as possible, and therefore the forward-looking approach for purposes of determining high-cost support amounts should be calculated, for *all* carriers, based on the *lesser* of the forward-looking cost of ILEC network technology or the forward-looking cost of wireless network technology. The Commission recently reaffirmed its "commitment to forward-looking costing principles," and explained that "[a] forward-looking costing methodology considers what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network 73/ Consistent with the Commission's theory of forward-looking cost, the Commission should make funding available based on the *lower* of the efficient forward-looking costs of ILEC real-world networks and the efficient forward-looking costs of real-world wireless networks, developed based on "the real-world attributes of the routing and topography" of such carriers' networks 74/ For example, Western Wireless demonstrated that, if universal service support were based on the lesser of ILEC forward-looking costs or wireless forward-looking costs, then there

72/ *See Ex Parte* Letter from David L Sieradzki, Counsel for Western Wireless Corp , to Magalie Roman Salas, FCC Secretary, CC Docket No 96-45 (Aug 26, 1998) (available at http //gullfoss2 fcc gov/prod/ecfs/retrieve cgi?native_or_pdf=pdf&id_document=2140160001 and http //gullfoss2 fcc gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=2140160002) ("*Western Wireless Model Ex Parte*")

73/ *TELRIC NPRM*, ¶¶ 29, 30

74/ *Id* at ¶ 52

could be a savings of 48% compared to providing universal service support based only on wireline technology 75/

As part of the process of re-examining the forward-looking cost analytical process, the Commission should reconsider some of the ILEC-centered assumptions it has made in its past modeling efforts For example, in the original Synthesis Model for high-cost universal service support, the Commission began with an assumption that the basic geographic unit of analysis was the ILEC wire center The Commission should consider dropping that assumption and, instead, use a technology-neutral geographic unit of analysis, such as counties or census-block-groups One advantage of such an approach is that data on the specific geographic boundaries and other features of such units are more readily available to the public than ILEC wire center and study area boundaries.

B. The Commission Should Establish a Competitively Neutral Methodology to Derive Support Amounts

Once the Commission has an analytical methodology in place to determine forward-looking costs for each specified geographic area, the next step is to establish the rules for deriving support amounts Western Wireless submits that such rules should meet each of the following criteria:

(1) As directed by the Tenth Circuit, the methodology for all carriers, rural as well as non-rural, must be "sufficient" and must be targeted to advance the statutory goals of "affordable" rates in high-

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75/ *Western Wireless Model Ex Parte*, Attachment 2 ("Universal Service The Wireless Solution"), at 19 cost areas that are "reasonably comparable" to those in urban areas. 76/

(2) The methodology must be competitively and technologically neutral Thus, it should not make any difference whether the geographic area is served by a rural ILEC, a non-rural ILEC, a competitive ETC, or some combination.

(3) The methodology should provide sufficient federal support for a carrier seeking to serve a given high-cost geographic area, regardless whether that area is located in a state with average costs that are above or below the national average

(4) The methodology should provide sufficient *federal* support to give states with costs well above the national average the resources to supply any needed intrastate support.

(5) The methodology should include "inducements" for states to take any necessary intrastate actions to eliminate implicit support, as required by the 1996 Act. 77/

There are a number of possible approaches that would satisfy these objectives Qwest Communications outlined one possible approach in its comments

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76/ *Qwest Corp v FCC*, 258 F 3d 1191 (10th Cir 2001) *See also Tenth Circuit Remand Order* ¶¶ 36-48 (clarifying FCC's definitions of key terms)

77/ *Qwest Corp v FCC, supra*

in the Tenth Circuit Remand proceeding 78/ Under Qwest's proposal, the current high-cost support mechanisms (model-based support and Interstate Access Support) would be replaced by what Qwest called "Tier One" and "Tier Two" support. Tier One Support would be based on a simple comparison of the cost of service in each area with a national benchmark (such as the $31 benchmark currently used in determining support for non-rural carriers). Tier Two Support (like the Model-Based Fund today) would be designed to provide funding to the highest-cost states that have the least ability to generate needed intrastate funding based on the divergence between the statewide average cost and the national average, while at the same time ensuring that the most rural areas are eligible for federal universal service funding While Qwest offered its proposal specifically for areas served by non-rural ILECs and their competitors, Western Wireless believes a similar approach could also be applied to areas served by rural ILECs and their competitors The Commission should seek further comment on this idea 79/

78/ Qwest Comments, CC Docket No 96-45 (10th Circuit Remand Proceeding) (filed April 10, 2002) *see also Ex Parte* Letter from John W Kure, Qwest, to Marlene H Dortch, Secretary, CC Docket No 96-45 (filed Oct 1, 2003) (summarizing Qwest's position on the Tenth Circuit remand)

79/ While the Commission did not adopt Qwest's proposal in the *Tenth Circuit Remand Order*, it did not altogether reject it either – the further NPRM mentions the proposal and seeks further comment on related issues *See Tenth Circuit Remand Order FNPRM*, ¶ 130 n.420

Another, similar alternative would be to provide increasing percentages of federal support for geographic locations of increasing cost. For example, the federal fund could provide 25% of the difference between the forward-looking cost and the benchmark average cost for locations with costs that are 135% to 150% of the national average, 50% for locations 150% to 200% of the average, 75% for locations 200% to 250% of the average, and 100% of the difference between the forward-looking cost and the benchmark average cost for locations with costs that are 250% of the national average

C. The Rules Must Include Inducements for Eliminating Implicit Subsidies from Retail Rates

Section 254 forbids the Commission from indefinitely maintaining implicit subsidies in the interstate rate structure, 80/ and at a minimum "states a clear preference" that states take complementary actions to eliminate implicit support from intrastate rates 81/ This is because, as the Commission has long recognized, "implicit subsidies have a disruptive effect on competition;" 82/ "may discourage efficient local and long distance competition in rural areas and limit consumer choice," 83/ and "may undermine efficient competition by permitting an incumbent carrier to price services below cost" 84/ Western Wireless submits that, consistent with the Tenth Circuit's ruling, the universal service high-cost support

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80/ *Texas Office of Public Utility Counsel v FCC*, 183 F 3d 393, 406 (5th Cir 1999), *Alenco*, 201 F 3d at 624, *Texas Office of Public Utility Counsel v FCC*, 265 F 3d 313, 318 (5th Cir 2001)

81/ *Tenth Circuit Remand Order*, ¶ 26, *see also Qwest Corp v FCC*, 258 F 3d at 1203, *AT&T Corp v Iowa Utilities Board*, 525 U S 395, 393-94 (1999) (noting that "§ 254 requires that [intrastate] universal service subsidies be phased out, so whatever possibility of arbitrage remains will be only temporary" in response to ILEC concerns that availability of unbundled network elements at TELRIC would enable entrants to avoid the burden of universal service subsidies built into ILECs' intrastate retail rates)

82/ *Access Charge Reform*, Order on Remand, 18 FCC Rcd 14976, 14977-78, ¶ 2 (2003)

83/ *MAG Order*, 16 FCC Rcd at 6-7, ¶ 6

84/ *Id*, n 193 *See also Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, 15995-96, ¶ 30 (1997) ("Implicit subsidies also have a disruptive effect on competition, impeding the efficient development of competition in both the local and long-distance markets For example, where rates are significantly above cost, consumers may choose to bypass the incumbent LEC's switched access network, even if the LEC is the most efficient provider Conversely, where rates are subsidized (as in the case of consumers in high-cost areas), rates will be set too low and an otherwise efficient provider would have no incentive to enter the market In either case, the total cost of telecommunications services will not be as low as it would otherwise be in a competitive market Because of the growing importance of the telecommunications industry to the economy as a whole, this inefficient system of access charges retards job creation and economic growth in the nation") structure for areas served by rural ILECs, as well as for non-rural ILECs, should include inducements for the ILECs and their state regulators to eliminate implicit support from their rate structures. By adopting a structure such as Qwest's two-tier proposal, the Commission would ensure that every state receives a reasonable amount of support, and the threat of depriving the state and its carriers of that support would establish an inducement to eliminate implicit subsidies

Western Wireless submits that the Commission should limit ILEC high-cost support unless their basic retail rates for residential universal service recover at least a minimal amount of revenue corresponding to an "affordable" rate under the statute 85/ Rural ILECs typically recover 50% to 75% of their revenues from universal service funding and access charges, not from their own customers; and a significant number of those carriers maintain unreasonably low retail rates 86/ Not only does this unhealthy dependence on high-cost support and access charges insulate these carriers from any incentive to be responsive to their own consumers' needs. It also means that, in cases where retail rates are extraordinarily

85/ This proposal is different from, and distinguishable from, SBC's proposal regarding an "affordability benchmark" for each geographic area, which the Commission rejected in the *Tenth Circuit Remand Order*, ¶ 45 SBC proposed setting high-cost support based on the difference, in each geographic area, between the forward-looking cost of service and an affordability benchmark determined based on a percentage of average household expenditure levels *See* SBC Comments, CC Docket No 96-45, at 15-16 (filed Dec 20, 2002) By contrast, Western Wireless' proposal here would simply preclude the disbursement of federal support to carriers that recover unreasonably low rates, below minimal "affordable" levels, from their end-users, in order to protect consumers across the country from providing unreasonable subsidies to such carriers The Commission should seek comment on specific implementation issues related to this proposal, such as the definition of "affordable" rate levels in each geographic area

86/ *See, e g* , Fred Williamson & Assocs , Inc , Comments, CC Docket No 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 11-12 (certain rural ILECs in Kansas receive only 17% of their revenue per access line from their end-user customers, and the remainder from interstate and intrastate access charges and universal service funds) low, consumers around the country, who pay into the high-cost fund, are being forced to provide unfairly generous subsidies

To be sure, rural consumers are entitled under the Act to rates that are "affordable" and "comparable" to rates available elsewhere, with the support of the federal high-cost universal service program But they are not entitled to subsidized rates *below* affordable and comparable levels. Such unreasonably low retail rates, maintained through regulatory policies, also pose a barrier to competitive entry.

Accordingly, Western Wireless submits that, in order to create inducements to eliminate implicit subsidies, the level of federal universal service support available to a carrier would be based upon whether a carrier's retail rates are at or above an "affordability" benchmark. 87/ Carriers whose basic retail rates are below that benchmark would be limited in the amount of support they are eligible to receive

V. THE COMMISSION SHOULD ESTABLISH RULES THAT GRADUALLY PHASE IN THE NEW FORWARD-LOOKING COST-BASED SYSTEM AND PROVIDE FOR A REASONABLE TRANSITION

Western Wireless recognizes that it is proposing a significant transformation in the high-cost universal service system and in the way rural ILECs are regulated. Accordingly, Western Wireless believes that a gradual transition plan is appropriate, as follows

87/ *See, e g*, Sprint Comments, CC Docket No 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 15-19

First, the new rules should not become effective until 2006, upon the expiration of the five-year period provided by the *RTF Order*, and should apply initially only to competitive ETCs, non-rural ILECs, and rural ILECs owned by relatively large holding companies The rules should be phased in more gradually for smaller rural ILECs Second, a transitional mechanism should be established such that no carrier's high-cost support is reduced by more than 20% in any one funding year Third, a "safety net" should be available under which a carrier could show, using clear criteria established in advance, that it needs additional support to avoid hardship

In the *RTF Order*, the Commission determined that the key elements of that plan would remain in place for a five-year stability period, running through mid-2006 88/ Similarly, in the *MAG Order*, the Commission concluded that the key features of the access charge reform plan adopted in that order should remain in place for the same five-year period. 89/ Western Wireless believes that the Joint Board and the Commission must keep their promises and deliver the regulatory stability that they promised to ILECs and competitive ETCs alike, which is crucial for investment and economic decision-making. However, it is certainly timely for the Commission to begin now to lay the groundwork necessary to begin eliminating

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88/ *RTF Order*, 16 FCC Rcd at 11309-10, ¶ 167

89/ *MAG Order*, 16 FCC Rcd at 10, ¶ 15

rate-of-return regulation as of the end of the 5-year RTF stability period, as was presaged in the *RTF Order* 90/

Western Wireless proposes that the new system of high-cost universal service funding and interstate access charge regulation be introduced in 2006, at the end of the five-year period of the RTF plan, and phased in gradually thereafter. Specifically, in 2006, the new universal service system should apply only to competitive ETCs, non-rural ILECs; and rural ILEC study areas with 100,000 or more lines in all affiliated study areas nationwide and/or 30,000 lines or more in all affiliated study areas statewide The plan would be extended in 2008 to rural ILEC study areas with 50,000 or more lines in all affiliated study areas nationwide and/or 15,000 or more lines in all affiliated study areas statewide, and in 2010 to rural ILEC study areas with 20,000 or more lines in all affiliated study areas nationwide and/or 5,000 or more lines in all affiliated study areas statewide The plan would not be applied to the smallest rural ILECs until 2012.

In order to prevent "rate shock" to carriers whose support payments are reduced, Western Wireless suggests that, in addition to the gradual implementation schedule proposed above, the plan be implemented in such a way that no ILEC study area loses more than a specified percentage (20 or 25 percent) of the amount of support it previously received in any one year "Hold-harmless" support should be made available, in addition to the forward-looking cost-based support, to ease the transition process Competitive ETCs operating in such a study

90/ *See RTF Order*, 16 FCC Rcd at ¶ 12

area would receive a comparable amount of portable support (on a per-line basis) for each customer connection they serve

Furthermore, as in the RTF plan, Western Wireless believes that a "safety net" supplementary support mechanism should be available If a carrier can prove that, in its particular circumstances, the amount of support is not sufficient to provide the basic universal services, an additional safety net or supplemental mechanism should be available for a limited period of time Specific criteria for such supplemental support would have to be adopted in advance. This would prevent rate shock and unduly rapid transitions for the RLECs, while ensuring an orderly change to the system based on forward-looking costs.

VI. THE COMMISSION SHOULD FURTHER REFORM RLEC INTERSTATE ACCESS CHARGES TO FULLY ELIMINATE IMPLICIT SUBSIDIES

As part of its elimination of ROR regulation of the RLECs, the Commission should seek comment on changes to the interstate access charge rules Specifically, the Commission should consider _rate structure_ rule changes needed to rebalance the rates charged by ROR carriers and eliminate all implicit subsidies embedded in those carriers' interstate access charges 91/ The Commission should

91/ *See Tenth Circuit Remand Order FNPRM*, ¶ 127 (encouraging states "to replace implicit support with explicit support mechanisms that will be sustainable in a competitive environment") Consistently, the Minnesota Public Utilities Commission recently commenced an inquiry into rebalancing of local rates and intrastate access charges, and related universal service rule changes, in order to eliminate implicit "subsidies that may inhibit the development of viable competition and the benefits it may yield in the form of consumer choice, service quality, efficiency, and as an impetus to technological advance Competitors cannot profitably enter local markets where they bear operation costs higher than the subsidized rates they must meet in order to compete" Statement of Proposed Inquiry, *Commission Investigation of Intrastate Access Charge Reform*, Docket No P-999/CI-98-674, *Universal Service Rulemaking*, also modify its policies regarding access charge *rate levels* of ILECs currently subject to ROR regulation. These policy changes should be coordinated with the Commission's broader efforts to reform and harmonize the rules governing inter-carrier compensation.

First, the Commission should significantly increase or eliminate altogether the caps on subscriber line charges ("SLCs"), which preclude ILECs from recovering the full cost of loops from end-users. The Commission has long recognized that ILECs incur loop costs on a non-traffic sensitive basis, that the most economically efficient way to recover those costs is on a non-traffic sensitive basis from the cost-causers (end-users); and that SLC caps constitute an implicit subsidy from access customers (and universal service contributors who pay into the ICLS fund) to end users. The Commission should put an end to such implicit subsidies. This does not necessarily have to lead to an increase in the rates charged to end-users. However, rather than relying heavily on implicit subsidy mechanisms such as SLC caps to ensure that end-user rates are reasonable and affordable, the Commission should instead use forward-looking cost-based universal service support to achieve reasonable end-user rates – but only to the extent needed, and only on a competitively-neutral basis.

Second, the Commission should seek comment on other rate structure changes to eliminate implicit subsidies from the interstate access rate structure,

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Docket No. P-999/R-97-309, *Commission Investigation of Cost for the Appropriate Level of Universal Service Support*, Docket No. P-999/CI-00-829, at p. 2 (issued Oct. 13, 2003) (available at http://www.puc.state.mn.us/docs/stmtofinq.pdf) such as the rule that local switching costs be recovered from long-distance carriers on a traffic-sensitive basis The Commission has recognized that ILECs incur the cost of the "port" component of local switching on a non-traffic sensitive basis, and many parties have argued that the remainder of local switching costs are largely, or possibly entirely, non-traffic sensitive. 92/ If these arguments are correct, then some or all of the local switching charges currently paid by long-distance carriers on a traffic-sensitive basis ought to be paid by end-users on a non-traffic sensitive basis.

Third, the Commission should modify its rules to set ILECs' access charge rate levels – *i e* , the SLCs and switching charges paid by end-users, as well as the local transport and any possible remaining local switching charges paid by long-distance carriers – based on forward-looking costs, rather than embedded costs As the Commission has made clear in recent access charge proceedings, it is possible to assess the reasonableness of access rates based on forward-looking costs 93/ Moreover, the Supreme Court has affirmed that forward-looking economic cost-based rates can be fully compensatory to the ILECs. 94/ Such reform is overdue and should be adopted with respect to all ILEC interstate access charges.

Fourth, with respect to future adjustments in access rate levels, the Commission should consider whether the existing price cap system that applies to

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92/ *See, e g* , AT&T Comments, CC Docket No 02-148, filed July 3, 2002, at 66-69.

93/ *Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps*, Order 17 FCC Rcd 10868 (2002) (evaluating the forward-looking costs of price cap ILECs loops, and concluding that a substantial proportion have costs in excess of the $6 50 SLC cap)

94/ *Verizon v FCC*, 535 US at 471

non-rural ILECs should be applied to the RLECs, or whether modifications to that system might be appropriate Moreover, the Commission should consider whether to adopt pricing flexibility rules comparable to, or different from, the measures that apply to the larger ILECs In particular, it might be appropriate to use the receipt of high-cost support by a competitive ETC as a "trigger" for certain types of pricing flexibility for the RLECs

Finally, access charge issues should be addressed in the context of the pending *Intercarrier Compensation* proceeding. Western Wireless supports the Commission's objective of ultimately reducing all forms of intercarrier compensation to zero, and requiring all carriers to recover revenues from their own customers rather than from other carriers. Eliminating ROR regulation of the RLECs should facilitate the Commission's accomplishment of its goals in this regard In particular, reduction of the excessive access charges collected by the RLECs will eliminate a competitive inequality from the rural marketplace, in that ILECs are entitled to impose tariffed access charges on long-distance carriers, but CMRS carriers are prohibited from doing so Reduction of RLEC access charges will also lead to economic efficiency and should benefit rural consumers, who currently suffer from a severely distorted long-distance and local marketplace

VII. CONCLUSION

For the foregoing reasons, the Commission should take expeditious action to phase out rate-of-return regulation as the basis for small and mid-size ILECs' universal service disbursements and access charges This would serve the public interest far more efficiently –and would control the growth of the fund much more effectively – than some of the anti-competitive proposals that the ILECs have advocated in the *Joint Board Portability Proceeding*. Instead of the antiquated, inefficient, and anti-competitive system of ROR regulation, the Commission should develop a regulatory system based on forward-looking cost.

Respectfully submitted,

WESTERN WIRELESS CORPORATION

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October 30, 2003

Rate of Return Regulation:
Problems That Can No Longer Be Ignored

ATTACHMENT A

to

Western Wireless Corporation's

**Petition For Rulemaking To
Eliminate Rate-Of-Return Regulation
Of Incumbent Local Exchange Carriers**

October 30, 2003

Rate of Return Regulation:
Problems That Can No Longer Be Ignored

Rate of Return Regulation: A Failed Model of Economic Regulation

Western Wireless Corporation ("Western Wireless") addresses the theoretical and practical problems that result from using an embedded cost/rate of return methodology to determine universal service funding for smaller incumbent local exchange carriers ("ILECs") in a separate paper, "Rate of Return Regulation: A Failed Model of Economic Regulation," released on June 3, 2003.[1] Western Wireless showed that carriers have both the incentive and ability to manipulate their embedded cost study results to maximize their universal service fund ("USF") and/or interstate access revenue and documented instances in which the Federal Communications Commission ("FCC") has found that carriers have done so. Western Wireless recommended that rate of return regulation for smaller ILECs be replaced by a system in which USF payments to all ILECs are based on forward looking economic costs ("FLEC"). Until such time as an appropriate FLEC model can be developed for smaller ILECs, Western also recommended that the FCC establish a stringent and comprehensive audit program over ILEC embedded cost studies to ensure the integrity of the high cost fund mechanisms.

In this Paper, Western Wireless further documents instances in which ILECs have manipulated their embedded cost studies to maximize their USF and/or access revenue. This time, Western Wireless focused its review on state commission proceedings in which large or small ILEC embedded cost studies were thoroughly scrutinized. State commissions typically conduct more comprehensive audits or reviews of carriers' cost studies than does NECA or the Commission, which, in itself, is a problem and raises the issue of lack of federal oversight of ILEC cost studies It is highly likely that, if conducted by NECA or the FCC, thorough audits of ILECs' USF and access cost studies would reveal problems similar to those identified by the states herein (the problems with the ILECs' federal cost studies would likely be of even greater magnitude given the historic lack of oversight)

The cost studies reviewed for this Paper were submitted in different types of proceedings rate cases, earnings investigations, state universal fund audits, and earnings sharing calculations under alternative regulatory mechanisms The lack of oversight of ILEC cost studies is also a problem at the state level because detailed reviews of carrier cost submissions have become less common in the last few years -- most states no longer regulate the former Bell Operating Companies ("BOCs") on a rate of return basis and many states either no longer or do not actively regulate the local rates of smaller ILECs and/ or cooperatives

The results of Western Wireless' review of state commission proceedings involving ILEC cost studies are striking In virtually all instances, significant problems with the carriers' cost submissions were identified that resulted in disallowances of specific cost items and/or a settlement with the carrier receiving significantly less than originally requested The abuses uncovered included misstated affiliate transactions, failure to fully and accurately identify and allocate nonregulated costs, inclusion of costs that were not related to the provision of regulated services, and accounting misclassifications

Kansas Case Study

In 1998, the Kansas Corporation Commission ("KCC") began a series of audits and general rate investigations of ILECs that received Kansas Universal Fund Support ("KUSF") to ensure that the level of support received by each carrier was based on its costs and that its rates were just and reasonable Many of these proceedings resulted in stipulated settlements with no detailed findings and conclusions, but simply a settlement that required the company to reduce its draw from the KUSF to eliminate excess intrastate earnings

JBN Telephone Company The telephone company claimed a revenue deficiency of $572,917, but after KCC scrutiny of its costs, JBN entered into a settlement agreement that required it to reduce intrastate revenues by $690,000 annually by reducing its draw form the KUSF [2]

Wilson Telephone Company The telephone company claimed a revenue deficiency of $142,459, but reached a settlement with the KCC that required it to reduce intrastate revenues by $148,000 [3]

Craw-Kan Telephone Cooperative The telephone company claimed a revenue deficiency of approximately $300,000, but agreed to reduce its intrastate revenues by $500,000 in a settlement with the KCC [4]

Bluestem and Sunflower Telephone Companies Bluestem and Sunflower are subsidiaries of Fairpoint Communications, a mid-sized holding company [5] One of the principal areas of contention was the management services agreement between the telephone companies and the holding company/service corporation The management services agreement governed the allocation of costs charged to the telephone companies for corporate and management services The findings of the KCC are revealing of the types of issues and problems that can be uncovered by a careful investigation of telephone company costs, including [6]

- Financial advisory fees paid to Fairpoint's investor/owners for advice on equity financing and strategic planning of $1 million were allocated to the telephone companies These were deemed not related to the provision of regulated services

- The cost of stock based compensation ($12 3 million), essentially stock dividends, was allocated to the telephone companies The staff found that "Rate Base rate of return regulation does not recognize dividends as part of the revenue requirement determination, therefore, the inclusion of this charge effectively provides a return to the corporate parent and a return or profit above the authorized return, to the investor "[7]

- Some nonregulated subsidiaries (e g , Fairpoint Solutions) appeared to receive no allocation of corporate costs and some of the proposed allocation factors effectively resulted in no costs being allocated to many nonregulated subsidiaries Some subsidiaries had zero or negative cost allocations

- Historically, management fee allocations were based on revenues, which do not necessarily reflect cost causation

- It was left to the General Manager's discretion to determine which accounts should be charged the management fees, potentially compromising the integrity of the companies' accounts

The KSS staff's recommendation was that only $10 6 million of Fairpoint's corporate costs should be allocated to its operating companies, compared to the $34 2 million Fairpoint had allocated for its 2000 test year Under the settlement agreement reached with Bluestem and Sunflower, the telephone companies were required to reduce their draw from the KUSF to zero

Southern Kansas Telephone Company In its review of Southern Kansas' cost studies, the KCC uncovered other ingenious attempts a misallocation of costs, including [8]

- Southern Kansas claimed deferred income tax asset included the effects of tax timing differences related to nonregulated expenses

- Southern Kansas claimed depreciation expense on plant that had been fully depreciated

- Southern Kansas failed to reflect a known and measurable increase in federal USF for the period when KUSF would be paid and rates would be in effect

- Payments to a consulting group that focuses on family relationships and the dynamics of families working together had not been shown to benefit regulated ratepayers

In the end, the KCC found that Southern Kansas had over earnings in excess of $2,828,214

Rural Telephone Company The KCC found the following transgressions on the part of Rural Telephone Company [9]

- Claimed more property tax expense than it had actually paid during the test year

- Calculated its depreciation expense on its largest outside plant accounts using depreciation rates in excess of those permitted by the KCC

- Included lobbying and corporate image advertising expenses, costs that benefit the company, not the regulated ratepayer

As a result of these, and other adjustments, the KCC found that Rural had excess intrastate revenues of $801,533

California Case Study

The California Public Utilities Commission's (CPUC) Office of Ratepayer Advocates (ORA) conducted an extensive audit of the affiliate and nonregulated transactions of Roseville Telephone Company ("RTC") and uncovered the following improper allocations of costs [10]

- RTC's CEO, CFO and their staffs had allocated only 8 out of 31,000 hours to affiliate and nonregulated operations
- RTC's VP of marketing had done some work for Roseville Cable, but the costs were not properly assigned to Roseville Cable
- RTC failed to assign any accounting, budget and finance development costs and the revenue accounting manager's time to Roseville Long Distance.
- RTC had allocated its information services costs based on out of date and incorrectly developed end user service order, payment and collection factors that underallocated RTC's computer infrastructure costs to affiliates and unregulated operations
- The cost of a valuation study related to the transfer of RTC's wireless interests to an unregulated affiliate were charged to RTC
- RTC failed to bill Roseville Cable for regulatory costs incurred for Roseville Cable
- Alarm Monitoring costs were inappropriately booked in RTC's regulated accounts
- Employee health insurance costs for an unregulated affiliate were paid by RTC
- RTC had booked the costs of institutional and goodwill advertising in its regulated accounts, in direct contravention of CPUC policies
- RTC failed to bill a substantial portion of the costs to establish its long distance affiliate to that affiliate
- RTC charged its wireless affiliate a market rate for office space rather than a fully distributed cost based rate as required by the CPUC

- RTC used on outdated factor to allocate land and building costs to its nonregulated activities which understated this allocation and failed to allocate any land and building costs to its affiliates

- The factor RTC used to allocate residual general and administrative costs to affiliates was inconsistent with the FCC's Part 64 Rules and understated the allocation to affiliates

- RTC expensed its entire software development costs in 1999, contrary to GAAP (SOP 98-1), even thought the software would be used in future years

These improper allocation of costs resulted in over earnings by RTC: in 1997, RTC's rate of return was 10.77% instead of the allowable 9.12%, in 1998, RTC's rate of return was 11.86% instead of the allowable 10.14%, and in 1999, RTC's rate of return was 14.60% instead of the allowable 10.55%

Washington Case Study

In 1995, U S WEST Communications (now Qwest) requested a general rate increase of over $204 million based on traditional rate of return regulation from the Washington Utilities and Transportation Commission ("WUTC") In 1996, the WUTC rejected the proposed rate increase and instead ordered Qwest to reduce its rates by $91 5 million.[11] Among the relevant findings and disallowances made by the WUTC were

- Costs related to a major restructuring program were disallowed because the benefits from the program had not yet been realized and current costs far exceeded benefits

- Corporate image advertising costs were disallowed

- The company's proposed jurisdictional separation factors allocated excessive costs to the intrastate jurisdiction compared to historical trends

- WUTC disallowed Qwest's bonuses, Team Awards and Merit Awards because the standards used did not benefit ratepayers, especially in light of the company's poor service quality record

- The WUTC rejected Qwest's attempt to use depreciation rates that the WUTC had recently rejected

- Qwest purchased procurement and warehouse services from an affiliate at prices based on the affiliate's costs plus a return These prices, however, exceeded the market prices for such services

- The WUTC disallowed certain R&D costs paid to affiliates, as their potential benefits to ratepayers could not be determined

- Certain payments to Qwest's corporate parent were disallowed because they were duplicative of functions the company performed itself, were not directly related to regulated operations, or were for corporate image advertising

- The company failed to reflect the deferred tax effects of its sale of several exchanges, sharing of excess earnings, and flow through of the tax consequences of its pension asset, resulting in a significant overstatement of its rate base

- The company failed to synchronize the interest expense used in its federal income tax calculation with the WUTC's allowed weighted cost of debt

Oregon Case Study

U S WEST Communications (now "Qwest") was required to submit a general rate filing to the Oregon Public Utility Commission ("OPUC") prior to expiration of its Alternative Form of Regulation ("AFOR") at the end of 1996 In its revenue requirement filing, Qwest requested an increase of $28 million The OPUC made the following findings [12]

- The OPUC disallowed a negative (debit) balance in Qwest's cross bar and step-by-step depreciation reserve accounts because the equipment had been retired in 1989 and a portion of the amount was due to equipment that had been used in Washington

- Qwest failed to reflect the reduction in expenses it experienced as a result of its sale of several exchanges

- The OPUC disallowed bonuses paid to Qwest management and executives because these bonuses were paid for achieving corporate financial goals, which benefited shareholders, not ratepayers

- The OPUC disallowed a significant portion of Qwest's accrual for accident and damage claims as the company had accrued amounts in excess of actual payments during the test period

- The direct costs of Qwest's reengineering program as well as extraordinary expenses incurred by the company due to the disruption the program caused in the company's operations were disallowed, as the benefits of this program had not been realized

Overall, the OPUC ordered Qwest to reduce its revenue requirement by $97 2 million

Idaho Case Study

In 1996, U S WEST Communications (now ("Qwest") requested a general rate increase for its price-regulated services of $38 million, a 58% increase (Qwest's request was later reduced to $15 million) from the Idaho Public Utilities Commission ("IPUC") The IPUC staff initially recommended a rate decrease of $32 million, later adjusted the decrease to approximately $20 million (many issues were settled, typically by splitting the difference between the company and staff positions) [13]

Based upon its review of Qwest's cost study, the IPUC made the following observations

- The company's claim for payments to affiliates was reduced because many of the payments were not for services related to the provision of basic local service
- Telephone concession and employee recognition expenses were reduced
- A portion of corporate image advertising was disallowed
- The company should have amortized its restructurings/reengineering expenses over 15 years rather than in one year because the benefits of the restructuring and reductions would be realized in the future
- Qwest agreed to forgo its proposed claim for recovery of its depreciation reserve deficiency
- Costs related to nonregulated services, such as alarm monitoring, CPE and inmate services, were removed from the company's revenue requirement
- A substantial portion of Qwest's software capital leases were not related to the provision of basic local service but rather supported CLASS and access services.
- The IPUC required Qwest to remove 20% of its fiber investment from its rate base because a substantial portion of its fiber was unlit
- Because a staff audit revealed that that a portion of its central office equipment was missing (i e , no longer in service), the company was required to reduce its central office investment

In the end, the IPUC required the company to reduce its rates by $327,000

Vermont Case Study

In 1999, the Vermont Public Service Board ("Board") initiated a proceeding to develop the "Vermont Incentive Regulation Plan" for Bell Atlantic-Vermont (now "Verizon") The plan required Verizon to freeze rates for its regulated services over the five-year life of the plan while providing Verizon with pricing flexibility for competitive and new services Prior to implementing the plan, the Board investigated Verizon's cost of service/revenue requirement to ensure that the company's existing rates were just and reasonable In its Order adopting the plan[14], the Board made a number of adjustments to Verizon's cost of service, such as

- The Board rejected Verizon's proposed reduction in the amortization period from 20 years (the period the Board had previously approved at Verizon's request) to 5 years, as the company had presented no compelling reason for the change

- The company was not permitted to recover its nonrecurring OSS costs related to providing unbundled network elements as these costs had already been recovered in wholesale and retail rates

- The Board rejected Verizon's proposed amortization of its restructuring costs and substituted an amount that also reflected Verizon's incremental savings from its restructuring program

- Because Verizon attempted to recover a portion of its net costs of its merger with NYNEX, even though it had previously claimed that the merger would result in substantial savings, the Board rejected Verizon's cost estimate and substituted its own which reflected merger related savings

- The Board rejected Verizon's proposed amortization of merger related severance costs, as it was a one time, nonrecurring event

- The Board reduced Verizon's R&D costs to reflect the effect of its recent sale of Bellcore

- Because the company could not explain why the expenses shown in its financial reports were higher than its claimed rate case expenses, it was required to reduce its cost of service by the difference

- The company was not allowed to recover its costs of LNP implementation because the FCC had found these were interstate costs and had developed a mechanism for their recovery

Based upon these transgressions, the Board found that Verizon was over-earning by approximately $23 million annually

The Vermont Board has also conducted rate investigations of a number of smaller ILECs in recent years While these proceeding have generally been resolved by stipulated settlements with no specific findings regarding the companies' revenue requirement filings, in all cases the settlement amount is less than the amount claimed by the company, in some cases considerably For example, Northland Telephone Company of Vermont requested a revenue requirement of $3,836,681 but settled for $3,242,617, a reduction of 15 5% [15] Similarly, Ludlow, Northfield and Perkinsville Telephone Companies requested a revenue requirement of $4,364,332 while the stipulated amount was $3,827,546, a reduction of 13 3% [16] And, Waitsfield-Fayston Telephone Company requested $13,122,618 but settled for $11,462,618, a reduction of 12 6% [17]

Conclusion

This brief review of state proceedings in which ILEC revenue requirement/cost of service filings were closely scrutinized strongly suggests that similar oversight of the cost support submitted by rate of return ILECs' for USF purposes would result in significant reductions in the size of the high cost fund Rate of return carriers have strong incentives to recover as much of their costs from regulated services as possible and, not surprisingly, they act on these incentives, especially in the absence of a strong oversight function And, with the proliferation of unregulated affiliates and services in recent years, the opportunities for cost shifting and cross-subsidization have increased

Clearly, under rate of return regulation, ILECs have the incentive to improperly allocate their costs in a manner that allows them to realize a financial windfall The most common improper accounting practices include the following

- Excessive charges from unregulated affiliates to regulated operations
- Under or no allocation of unregulated costs to unregulated operations
- Retired plant treated as still in service
- Depreciation and amortization costs in excess of allowed amounts
- Understated charges from the regulated operation to unregulated affiliates
- Accounting misclassifications
- Overstated expenses and investment

These improper accounting practices were uncovered in anticipated state commission proceedings that the carriers knew would result in close scrutiny of these cost studies. Because ILEC cost studies submitted to NECA and the FCC are not subject to much scrutiny, the incentive and ability for carriers to overstate their costs is significantly higher than in the state commission cost study proceedings These problems could be avoided by adopting a FLEC methodology as the basis for high cost funding

Endnotes

[1] *See Rate of Return Regulation A Failed Model for Economic Regulation* (Attachment B to this Petition) That document was also submitted as Attachment C to Reply Comments of Western Wireless Corporation, In the Matter of Federal-State Joint Board on Universal Service, CC Docket No 96-45, June 3, 2003
[2] In the Matter of an Audit and General Rate Investigation of JBN Telephone Company, Inc , Docket No 02-JBNT-846-AUD, Joint Motion to Approve Stipulation and Agreement, Nov 2002
[3] In the Matter of an Audit and General Rate Investigation of Wilson Telephone Company, Inc Docket No 02-WLST-210-AUD, Joint Motion to Approve Stipulation and Agreement, July 2002

[4] In the Matter of an Audit and General Rate Investigation of Craw-Kan Telephone Cooperative, Inc , Docket No 01-CRKT-713-AUD, Joint Motion to Approve Stipulation and Agreement, October 2001
[5] In the Matter of an Audit and General Rate Investigation of Bluestem Telephone Company, Inc , Docket No 01-SSTT-878-AUD, In the Matter of an Audit and General Rate Investigation of Sunflower Telephone Company, Inc , Docket No 01-SFLT-879-AUD, Joint Motion to Approve Stipulation and Agreement, April 2003

[6] Id , Staff's Report and Recommendation on the Management Services Agreement Filed September 27, 2002, October 2002
[7] Id , p 15
[8] In the Matter of an Audit and General Rate Investigation of Southern Kansas Telephone Company, Inc , Docket No 01-SNKT-544-AUD, Non-Confidential Order Setting Revenue Requirements, September 2001

[9] In the Matter of an Audit and General Rate Investigation of Rural Telephone Company, Inc , Docket No 01-RLLT-083-AUD Order Setting Revenue Requirements, June 2001
[10] In the Matter of the Application of Roseville Telephone Company (U 1015 C) to Review Its New Regulatory Framework, Application 99-03-025, Decision, June 28, 2001
[11] Washington Utilities and Transportation Commission v U S WEST Communications, Inc , Docket No UT-950200, Commission Decision and Order Rejecting Tariff Revisions, Requiring Refiling, April 1996
[12] Re Application of U S WEST Communications for an Increase in Revenues, Docket No UT 125, Order No 97-171, May 19, 1997
[13] Re The Application of U S WEST Communications for Authority to Increase its Rates and Charges for Regulated Title 61 Services, Case No USW-S-96-5, Order No 27100, August 27, 1997
[14] Investigation into an Alternative Regulation Plan for new England Telephone and Telegraph d/b/a Bell Atlantic-Vermont, Docket No 6167, Order, March 24, 2000
[15] Investigation into the existing rates of STE/NF Acquisition Corp d/b/a Northland Telephone Company of Vermont, Docket No 6474, Order, October 3,2001
[16] Investigation into the existing rates of Ludlow Telephone Company, Northfield Telephone Company, and Perkinsville Telephone Company, Docket No 6576, Order, April 11,2002
[17] Investigation into the existing rates of Waitsfield-Fayston Telephone Company, Docket No 6417, Order, January 9,2001